The Message from Basel

By U.S. Senator Edward E. Kaufman

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Introduction

Mr. President, since last February, I have spoken at great length on what I viewed and continue to view as the key issue in financial reform – that of "too big to fail." As my colleagues know, I sponsored legislation with Senator Brown and others that would have placed strict limits on the size and riskiness of megabanks, but that did not pass. Instead, Congress placed its faith in regulators to set appropriate prudential standards for these institutions.

The issue of "too big to fail" has therefore not gone away with the passage of the landmark Dodd-Frank bill. It remains the most pressing issue for regulators – and for all of us. As Fed Chairman Ben Bernanke stated recently in testimony before the Financial Crisis Inquiry Commission: "If the crisis has a single lesson, it is that the too-big-to-fail problem must be solved."

Given that, financial regulations being developed nationally and internationally will be judged by one critical standard: do they address the core problem of too big to fail? This will be my last Senate speech on this issue, and I will be focusing on whether the recent rules coming out of Basel, Switzerland – and that will be considered in the upcoming G20 meeting in Seoul – meet this standard.

Basel III

Mr. President, the oversight body of the Basel Committee on Bank Supervision recently came to agreement on a core pillar of the Basel III framework of bank capital and liquidity standards. The agreement comes approximately two years after the original onslaught of the financial crisis and only a couple of months after the passage of a landmark financial reform bill in this Congress. This represents a rather quick turnaround for complex and oftentimes fractious international negotiations on financial regulation.

The new Basel III agreement also effectively increases the amount of common equity that banks must hold as a percentage of their risk weighted assets from 2%

to 7%. Importantly, this change not only raises the international bar on the amount of capital that banks hold, but also the quality of the capital that they hold – that is, more of their capital will need to be held in the form of common equity and retained earnings. In addition, this minimum risk-weighted capital ratio would also be supplemented – for the first time on an international level – by a leverage limit (of three percent), a ratio that reflects the amount of capital that a bank holds relative to the size of its assets.

While I commend the Committee on its efficiency and for producing a proposal that significantly strengthens existing international capital standards, I see several problems and flaws with regard to both the design and implementation of these rules.

Weak Standards

First, the standards are still too weak and will take way too long to be implemented. Even with the greater focus on high-quality equity capital, large U.S. bank holding companies are generally already well above the Basel III standards, which they won't have to comply with until 2019. And while the introduction of a leverage ratio has been hailed as a major achievement, it is subject to a long test and implementation period and is set at such a low level as to be mere window dressing. In fact, it would still permit financial institutions to leverage their balance sheets more than 33 times over their capital base, which is well above the gross leverage level at Lehman before it went into bankruptcy.

Flawed Risk-based Rules

Second, given the weakness of the leverage ratio, it is even more incumbent on negotiators to go back to the drawing board on the flawed risk-based standards of Basel II. In short, determinations on capital adequacy under the Basel rules will continue to be dependent on arbitrary risk weights, the judgments of rating agencies and the banks' own internal models. Instead of correcting the fundamental flaws of Basel II, Basel III continues to walk on its Achilles heel.

The final financial reform bill partially addresses this problem by removing all references to credit rating agency ratings in federal regulations. But since the Basel regulatory capital rules depend heavily on credit rating agency determinations, U.S. regulators are currently struggling to find a viable alternative. This is no doubt a tough task given that the use of ratings is at least as pervasive in the world of financial markets as it is in the world of financial regulations.

Late Liquidity Standards

Third, the Basel Committee punts on a global liquidity standard. With all the focus on capital requirements, it is easy to forget that liquidity rules are at least as important, if not more so. After all, Lehman Brothers was deemed adequately capitalized only days before a run on the firm evaporated its liquidity. Other institutions that were reportedly adequately capitalized also had fatal or near-fatal experiences due to liquidity runs.

The Basel Committee initially proposed a fairly robust liquidity proposal late last year. Under it, banks would be subject to a liquidity coverage ratio (LCR) requiring them to hold enough hi-grade liquid assets to cover potential cash needs over a 30-day period. They would also be subject to a net stable funding ratio (NSFR) requiring them to have sufficient sources of stable funding based upon the overall liquidity profile of their assets. Such a standard would help limit overreliance on unstable wholesale financing sources, a cause of the financial crisis that I will discuss in greater detail later in this speech. Unfortunately, in the face of a vocal industry backlash, the Committee watered down the proposals in July and has further backtracked on these standards in its most recent release. Both are also subject to a long "observation period." In fact, the actual standards on the LCR and NSFR, which are likely to be much weaker than the initial proposals, will not be introduced until 2015 and 2018, respectively.

Instead of waiting on uncertain and delayed Basel rules, U.S. regulators can set their own liquidity rules and/or use new powers granted by Dodd-Frank to place basic limits on the use of short-term debt (including repos) by systemically significant financial institutions. In the years prior to the crisis, the repo market morphed from a means for money-center banks to use high-quality collateral like Treasuries to secure overnight liquidity to being a convenient way for banks finance the booming securitization machine. Unfortunately, the use of repos and other forms of short-term borrowing to finance massive inventories of illiquid structured securities backed by dubious collateral led to serious structural weaknesses at the heart of our financial system. Placing basic limits on this practice would add greater stability to our financial system. Indeed, if financial institutions had to use more expensive longer-term funding to finance risky assets, we would likely see fewer risky and needlessly complex financial assets being created. As a recent study by the Bank of International Settlements shows, the effect of higher capital and liquidity requirements will likely strengthen financial stability without hindering economic growth.

Too Big to Fail Measures

Finally, the Basel Committee has yet to specifically address the problem of "too big to fail." Although the Committee notes that systemically significant banks should have "loss absorbing capacity" that goes beyond these basic standards, it has yet to provide much in the way of details of what this will entail. Ultimately, systemically important banks might need to hold some combination of the following: additional capital; contingent capital that converts from debt to equity when overall capital levels drop below a minimum threshold; and so-called bail-in debt that would subject holders of the debt to an expedited cram-down in cases where the institution was distressed. Presently, concepts such as contingent capital and bail-in debt, neither of which is a high-quality form of capital, raise more questions than answers with regard to how expensive a form of capital they would be and how they would work in practice. Indeed, the Basel Committee itself continues to explore these issues as reflected by a recent consultative document. And while the Committee calls for a "well integrated approach" on the supervision of systemically significant institutions, it seems more likely that the regulation of these firms will differ depending on national jurisdictions.

Under the new financial reform law, the Federal Reserve must set capital and other prudential standards that are more stringent for systemically risky institutions than they are for other financial institutions. It can also set graduated capital requirements that rise as banks and other financial institutions grow bigger and more complex. In addition, the Fed can set countercyclical capital rules that require banks to build up capital buffers during a bubble. While the Basel agreement also calls for such countercyclical rules, national regulators will have great discretion on when and how to implement them.

But to truly address "too big to fail," regulators will ultimately need to limit the size, complexity and riskiness of megabanks. The final financial reform bill has a number of provisions that have the promise of doing this, if regulators avail themselves of them. For example, the final bill's inclusion of the Kanjorski provision will give regulators the explicit authority to break up megabanks that pose a "grave threat" to financial stability. In addition, the requirement that systemically significant firms develop "living wills" allows regulators eventually to force an institution to shed assets if it fails to submit a credible resolution plan. Because resolution authority does not work for global mega-banks sprawled across many borders, I believe it will be imperative for regulators to use these powers.

Conclusion

Mr. President, I hope we ultimately take heed of the lesson that Chairman Bernanke identified. While the Basel III framework will be useful in setting minimum international standards, U.S. and other national regulators will need to go far beyond it to address the problem of "too big to fail." Of course, I would have preferred to have solved this problem by drawing simple statutory lines, such as those put forward in the Brown-Kaufman amendment. The Dodd-Frank bill instead takes a different tack, leaving critical decisions in the hands of the regulators. Its ultimate success or failure will therefore depend on the actions and follow-through of these regulators for many years to come.

As I have said before, Congress has an important role to play in overseeing the enormous regulatory process that will ensue following the bill's enactment. The American people, for that matter, must stay focused on these issues, if just to help ensure that Congress indeed will fulfill its oversight duty and its duty to intervene if the regulators fail. Although I will be leaving the Senate in November, I will be watching to see if the regulators have learned the lesson to which Chairman Bernanke refers and are willing to take the tough steps to solve the "too big to fail" problem.